Office of Chief Counsel
Internal Revenue Service
# memorandum
CC:WR:RMC:DEN:TL-N-2298-00
AMHarbutte

date: June 16, 2000

to: Gene Bybee, Revenue Agent
LMSB, Salt Lake City Utah

from: Alice M. Harbutte, Attorney, Denver, Colorado

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subject: [redacted]'s Pre-Filing Agreement
FYE [redacted]

This memorandum is in response to your request for advice on an issue concerning the application of I.R.C. § 195 to the target company involved in an acquisition.

**ISSUE**

1. Whether fees incurred by a Target Company expended in order to evaluate the various purchase proposals the Target Company received are included in the definition of "start-up expenditures" under I.R.C. § 195(c).

**FACTS**

On [redacted], [redacted]'s and [redacted], [redacted] entered into an Agreement and Plan of Merger pursuant to which [redacted]'s acquired all of the outstanding securities of [redacted] and [redacted] became a subsidiary of [redacted]'s. On [redacted], [redacted]'s publicly announced that it had agreed to buy [redacted] for $[redacted] in stock. On [redacted], a Joint Proxy Statement and Prospectus was issued by both [redacted]'s and [redacted] to their shareholders so that they could evaluate the merger. The stockholders of both [redacted]'s and [redacted] approved the merger. The acquisition of [redacted] by [redacted]'s required FTC approval. The FTC required [redacted]'s to divest itself of certain assets. The merger was finally consummated on [redacted]. [redacted]'s takes the position that for purposes of I.R.C. § 195(c)(2)(B) the acquired trade or business began on [redacted], so that the amortization period for any I.R.C. § 195(c) expenses begins on this date even though these expenses were incurred prior to [redacted].

On [redacted], [redacted], requested to participate in the Service's Pre-filing Agreement Pilot program announced in Notice 2000-12. Their application to participate was accepted by the Service. Pursuant to Notice 2000-12, the purpose of the pre-filing program is for the taxpayer and the Service to agree on the tax treatment of certain items limited to those items set forth in Notice 2000-12. Specifically with respect to [redacted]'s, the tax items under consideration are certain expenses relating to the acquisition by [redacted]'s of [redacted]. The tax return in question is for [redacted]'s fiscal year ended [redacted] and is due to be filed by [redacted]. Notice 2000-12 provides that a pre-filing agreement may cover: "The determination of which costs are investigatory costs incurred to determine whether to enter a new business and which business to enter for purposes of qualifying as start-up costs under § 195. See Rev. Rul. 99-23, 1999-20 I.R.B. 3."

One issue which has arisen in the pre-filing examination concerns expenses incurred by [redacted] in connection with the [redacted]'s acquisition. [redacted] engaged the [redacted], by engagement letter dated [redacted], to evaluate strategic alternatives on behalf of [redacted] with respect to "a potential transactions with the Company." Pursuant to this letter, [redacted] agreed to pay [redacted] as follows:

(a) a retainer fee of $[redacted] payable in cash upon execution of the engagement letter. This fee was expressly non-refundable but the parties agreed to credit it against the success fee, defined below.

(b) a success fee in the amount of [redacted]% ([redacted] basis points) of the consideration involved in the transaction.

(c) a termination fee of $[redacted] if the transaction is not consummated.

The proxy letter sent to the shareholders of both [redacted]'s and [redacted] regarding the acquisition, stated that [redacted] was hired by [redacted]'s to analyze the merger of [redacted] and [redacted]'s. The proxy statement also informed shareholders that [redacted] had hired [redacted] to evaluate strategic alternatives on behalf of [redacted].

As part of the pre-filing request, [redacted]'s has provided a list of expenses incurred by [redacted] in connection with the acquisition of [redacted] by [redacted]s. Included in this list are consulting fees paid to [redacted] in the amount of $[redacted] and fees paid by [redacted] to various attorneys and accountants some of which are directly related to the [redacted]'s acquisition and other fees which relate to the evaluation of various other proposals received by [redacted] submitted by other interested purchasers.

## DISCUSSION

Section 195(a) of the Code provides generally that no deduction shall be allowed for start-up expenditures, unless otherwise specified in this section. Section 195(b) provides that start-up expenses may, at the election of the taxpayer, be treated as deferred expenses which shall be allowed as a deduction prorated equally over a period of not less than 60 months.

The term "start-up expenditure" is defined at section 195(c)(1) and contains a two-part test. Both parts of the test must be met in order for an expense to qualify as a "start-up" expenditure.

First, under I.R.C. § 195(c)(1)(A) in order to qualify as a start-up expense the expenditure must be an amount that was paid or incurred in connection with:

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade business.

A target company that is acquired by another entity during a merger does not meet any of these requirements. The target company is not investigating the acquisition of an active trade or business but is selling a business. The expenses incurred by [redacted] were to evaluate the various purchase proposals it received. A target of an acquisition does not meet any of the requirements set forth at I.R.C. § 195(c)(1)(A).

The second test set forth in the statute is found at I.R.C. § 195(c)(1)(B) and requires that expenses which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subsection (c)(1)(A)), must be allowable as a deduction for the taxable year in which paid or incurred, (i.e. they must be ordinary and necessary and not capital). Thus, an expenditure that is considered a capital expenditure in an existing business is not included in the definition of start-up expenditure.

Accordingly, even if [redacted], the target company, were to meet the first test set forth at I.R.C. § 195(c)(1)(A), the expenses paid to [redacted] and any other expenses paid in connection with the takeover of [redacted] by [redacted]'s would be capital expenses. Under INDOPCO, a target entity, is required to capitalized fees paid to consultants, accountants, and attorneys that were incurred in a friendly takeover. These types of expenses are not deductible under I.R.C. 162 but are considered to be long-term benefits to the acquired entity and thus, capitalization of these fees is required. INDOPCO v. Commissioner, 503 U.S. 79 (1992). The Supreme Court in INDOPCO further stated:

> Courts have long recognized that expenses such as these, "'incurred for the purposes of changing the corporate structure for the benefit of future corporations are not ordinary and necessary business expenses.'" INDOPCO, 503 U.S. at 89.

As a result, the expenses incurred by [redacted] do not qualify under I.R.C. § 195(c) as start-up expenses.

**CONCLUSION**

If you have any questions concerning this matter please call Attorney Alice M. Harbutte at (303) 844-3258.

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